Summary

In the absence of significant legislative changes and assuming that the economy follows the path described in this report, the Congressional Budget Office (CBO) projects that the total surplus will reach $281 billion in 2001. Such surpluses are projected to rise in the future, approaching $889 billion in 2011 and accumulating to $5.6 trillion over the 2002-2011 period. That total is about $1 trillion higher than the cumulative surplus projected for 2001 through 2010 in CBO's July 2000 report. About $600 billion of the $1 trillion increase is due simply to shifting the 10-year horizon out one year, to 2011, and dropping 2001 from the total. The remaining $441 billion results mostly from changes in the economic forecast, which are offset in part by the cost of legislation enacted since CBO's previous report.

Perhaps more important to some policymakers, the on-budget surplus (which excludes the spending and revenues of Social Security and the Postal Service) is anticipated to equal $125 billion in 2001—a nearly $40 billion increase from its level in 2000. The on-budget surplus will continue growing over the 10-year period, CBO projects, exceeding $550 billion in 2011 and totaling over $3.1 trillion between 2002 and 2011.

The growth of economic activity—as measured by real (inflation-adjusted) gross domestic product (GDP)—is likely to slow from its rapid pace of recent years to about 2.4 percent this calendar year. Spending by consumers and investment by businesses slowed late last year in response to the rise in interest rates during 1999 and early 2000 and to reduced expectations about future business conditions. Although the Federal Reserve Board in early January responded to the slower growth by lowering the federal funds rate, spending by consumers and businesses is likely to remain weak in the near term. However, lower interest rates this year will set the stage for moderately faster growth of spending next year. Thus, CBO forecasts that economic growth will climb to about 3.4 percent in calendar year 2002.

How is it, then, that budget projections are getting better when the economy seems to be getting worse? There are two main answers to that question. First of all, the dip in the economy is expected to be short-lived. CBO forecasts that economic growth will pick up again by the middle of 2001. Over the 2002-2011 period, CBO anticipates that growth of real GDP will average a little over 3 percent per year —about 0.3 percentage points above its 10-year projection in July. That increase reflects a change in CBO's method of calculating the contribution of capital to growth, revised data showing greater investment for the past three years, and higher projected levels of investment. Changes due to higher projections of GDP and other economic factors boost projected revenues by $802 billion from 2001 through 2010.

Second, recent economic conditions and actions by the Federal Reserve have led CBO to significantly reduce its forecast of interest rates in 2001 and 2002 (but that factor is not nearly as large as the first). Lower near-term interest rates and reduced levels of projected debt across the 10-year period (due to higher projected surpluses) combine to increase estimates of the surplus by about $140 billion from 2001 through 2010.

Summary Table 1.
The Outlook for the Budget Under Current Policies (By fiscal year, in billions of dollars)

	Actual 2000	2001	2002	Total, 2002-2006	Total, 2007-2011	Total, 2002-2011
On-Budget Surplus	86	125	142	987	2,135	3,122
Off-Budget Surplus	150	156	171	1,019	1,468	2,488
Total Surplus	236	281	313	2,007	3,603	5,610

SOURCE: Congressional Budget Office.

The Budget Outlook

The outlook for the federal budget over the next decade continues to be bright. Assuming that current tax and spending policies are maintained, CBO projects that mounting federal revenues will continue to produce growing budget surpluses for the next 10 years. CBO's updated budget outlook continues a trend of steady and sometimes dramatic improvement in budget projections since 1997, reflecting the continuing impact of strong economic growth over the past few years. Although there are signs that economic growth is moderating from recent robust levels, substantial budget surpluses remain on the horizon for the next decade in the absence of large changes in policy. Over the longer term, however, budgetary pressures linked to the aging and retirement of the baby-boom generation threaten to produce record deficits and unsustainable levels of federal debt.

CBO projects that, in the absence of new legislation, total budget surpluses would grow from about 3 percent to more than 5 percent of GDP from 2002 through 2011.[1] Under current policies, total surpluses would accumulate to an estimated $2 trillion over the next five years and $5.6 trillion over the coming decade (see Summary Table 1). Such large surpluses would be sufficient by 2006 to pay off all debt held by the public that will be available for redemption.

1. These estimates assume that discretionary spending—which is provided and controlled in appropriation acts—grows over the 10-year period at the rates of inflation specified in the Balanced Budget and Emergency Deficit Control Act of 1985.

Within those totals, on-budget surpluses would accumulate to nearly $1 trillion over the next five years and about $3.1 trillion over the 2002-2011 period. On-budget surpluses would range between just over 1 percent to more than 3 percent of GDP. Off-budget surpluses also would total about $1 trillion over the next five years and about $2.5 trillion through 2011. Off-budget surpluses alone would be sufficient to eliminate the debt available for redemption by the end of the 10-year period.

The distinction between on- and off-budget surpluses is significant for the budget policy debate. Many lawmakers have declared their intent to preserve all off-budget surpluses, which consist principally of the surpluses generated by the Social Security trust funds, thereby reducing the outstanding public debt. As a result, on-budget surpluses are viewed by those lawmakers and others as establishing the budgetary boundaries for any new spending or revenue policies.

Changes Since July 2000

CBO's current budget outlook is more favorable than the one presented in July 2000. Since then, the Congress and the President have enacted legislation that, CBO estimates, increases projected spending over the 2001-2010 period by about $561 billion and reduces projected revenues by $37 billion, compared with the levels in CBO's July baseline (see Summary Table

2). About two-thirds of that increase in projected spending results from extrapolating discretionary spending into the future on the basis of the level of appropriations for 2001. Expanded health care benefits for military retirees and increased payments for Medicare—along with additional debt-service costs resulting from legislative changes—account for most of the rest of the decrease in the cumulative surplus. The effects of legislation, however, have been more than offset by changes in CBO's estimates of future revenues that add to projected surpluses.

Most of the improvement in CBO's budget outlook since July results from changes in economic projections. Despite an expected short-term reduction in economic growth, CBO estimates that the economy will grow faster after 2001 than it estimated in July. That increase in growth boosts projected revenues by more than $800 billion over the 2001-2010 period.

CBO projects that interest rates will be at least 1 percentage point lower in both 2001 and 2002 than previously forecast. As a result, projections of net

Summary Table 2.
Changes in CBO's Projections of the Surplus Since July 2000
(By fiscal year, in billions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Total, 2001-2010
July 2000 Projection of Total Surplus[a]	268	312	345	369	402	469	523	565	625	685	4,561
Changes											
Legislative											
Revenues	-2	-2	-3	-3	-3	-4	-4	-5	-6	-5	-37
Outlays[b]	-12	-40	-46	-51	-56	-60	-66	-71	-77	-83	-561
Subtotal	-14	-42	-49	-53	-59	-63	-70	-76	-83	-88	-598
Economic											
Revenues	-6	7	32	56	72	88	106	128	148	173	802
Outlays[b]	7	14	10	10	12	16	19	24	29	37	178
Subtotal	1	21	42	66	84	103	124	151	177	210	980
Technical											
Revenues	33	29	24	20	15	11	9	7	4	2	153
Outlays[b]	-6	-7	-3	-5	-10	-14	-13	-12	-12	-12	-95
Subtotal	27	22	21	15	6	-3	-4	-6	-8	-10	59
Total Changes	13	*	14	28	31	36	50	70	86	111	441
January 2001 Projection of Total Surplus	281	313	359	397	433	505	573	635	710	796	5,002
Memorandum:											
Total Change in Revenues	25	34	53	73	84	95	110	129	146	170	919
Total Change in Outlays[b]	-12	-33	-38	-45	-53	-59	-60	-59	-60	-58	-478

SOURCE: Congressional Budget Office.

NOTE: * = less than $500 million.

a. The stated surplus assumes that discretionary spending grows at the rate of inflation after 2000 (one variation of the baseline described in CBO's July report).

b. Increases in outlays are shown with a negative sign because they reduce surpluses.

interest are lower by $12 billion in 2001 and $21 billion in 2002. At the same time, higher revenue projections and other factors reduce the projected costs of servicing the debt by a total of $160 billion over the 10-year period.

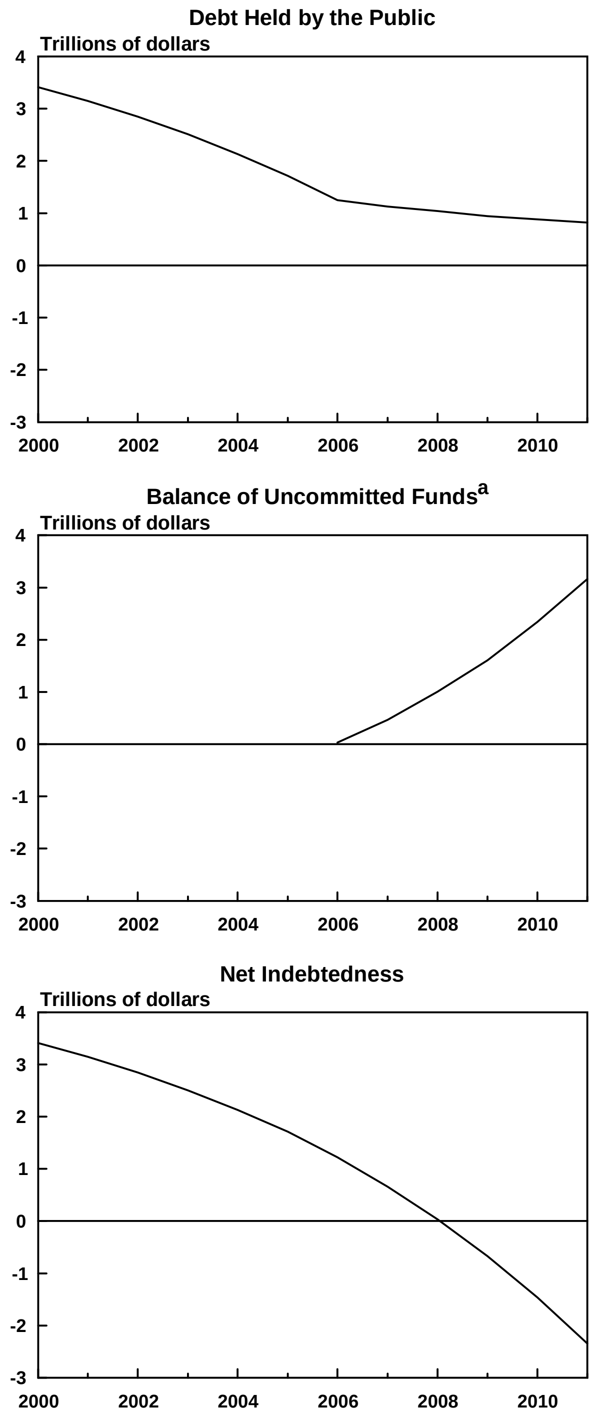
Changes in factors other than legislation and the economic outlook (so-called technical changes) increase projected surpluses by $59 billion over 10 years. Technical changes to revenue projections increase surpluses by $153 billion—mostly reflecting an increase in projected realizations of capital gains in the first half of the period and collections of revenues in fiscal year 2000 that were greater than anticipated in July. Technical changes to outlay projections offset $95 billion of the increase in revenues between 2001 and 2010 through a mix of modifications in both directions. Among the largest are upward revisions for Medicaid and Social Security, which are only partially offset by downward reestimates for discretionary spending (mostly Section 8 housing assistance); estimates of greater receipts from auctions of licenses to use portions of the electromagnetic spectrum; and lower debt-service costs.

Projections of Federal Debt

Between 1969 and 1997, the Department of the Treasury sold ever-increasing amounts of securities to finance continuing deficits. As a result, debt held by the public climbed each year, peaking at $3.8 trillion in 1997. But that trend has been reversed. Debt held by the public has dropped $363 billion, to $3.4 trillion at the end of fiscal year 2000.

CBO's baseline indicates that debt held by the public will continue to fall (see Summary Figure 1). If surpluses accrue as projected, much of the current debt will be paid down over the next several years; however, a part of it—including some long-term bonds and savings bonds—will not be available for redemption during CBO's 10-year projection period. Therefore, in any given year, some debt will remain outstanding and incur interest costs, regardless of the size of the surplus. Under CBO's assumptions for the baseline, surpluses exceed the amount of debt available for redemption beginning in 2006. After that point, surpluses not used to pay off debt accumu-

Summary Figure 1.
CBO's Projections of Federal Debt, Uncommitted Funds, and Net Indebtedness
(By fiscal year, in trillions of dollars)



SOURCE: Congressional Budget Office.

a. CBO's term for the surpluses remaining in each year after paying down publicly held debt available for redemption. Uncommitted funds accumulate from one year to the next.

late and are assumed to earn a rate of return equal to the average rate projected for Treasury securities.

CBO displays the full effect of surpluses on the government's financial position with a new measure —net indebtedness—which combines the outstanding debt held by the public and the balance of uncommitted funds. In 2006, by CBO's estimates, the surplus would be large enough to reduce debt held by the public to $1,251 billion; however, another $28 billion would be available to the Treasury but not applied to debt redemption because the remaining debt will have not yet reached maturity, will not be available for repurchase at a price that the Treasury would be willing to pay, or will be held in nonmarketable form (for example, savings bonds). The government's net representation in financial markets (net indebtedness) would therefore total $1,223 billion—the difference between debt held by the public of $1,251 billion and $28 billion in uncommitted funds. Under CBO's baseline projections, net indebtedness turns negative after 2008, meaning that the balance of uncommitted funds at that point would exceed the remaining debt owed to the public.

The Economic Outlook

Real GDP is expected to grow half as fast in calendar year 2001 as it did in 2000, dropping from 5.1 percent to 2.4 percent. That rate of growth is expected to pick up in 2002 to 3.4 percent.

The rate of inflation, measured by the change in the consumer price index (CPI) for urban consumers, is expected to decline from 3.4 percent in calendar year 2000 to around 2.8 percent in 2001. That projected decline reflects CBO's view that oil prices will fall somewhat from last year's level, although the underlying inflationary pressure from the tight labor market will remain.

CBO anticipates that growth of real GDP will average about 3 percent in the 2002-2011 period. (CBO does not attempt to forecast year-to-year patterns in the business cycle more than two years

Summary Table 3.
CBO's Economic Projections for Calendar Years 2001-2011

	Estimated	Forecast		Projected Annual Average	
	2000	2001	2002	2003-2006	2007-2011
Nominal GDP (Percentage change)	7.3	4.7	5.6	5.1	5.0
Real GDP (Percentage change)	5.1	2.4	3.4	3.1	3.1
GDP Price Index (Percentage change)	2.1	2.3	2.1	1.9	1.9
Consumer Price Index[a] (Percentage change)	3.4	2.8	2.8	2.6	2.5
Unemployment Rate (Percent)	4.0	4.4	4.5	4.7	5.2
Three-Month Treasury Bill Rate (Percent)	5.8	4.8	4.9	4.9	4.9
Ten-Year Treasury Note Rate (Percent)	6.0	4.9	5.3	5.6	5.8

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

NOTES: Percentage changes are year over year.

a. The consumer price index for urban consumers.

ahead, but that average figure for economic growth takes into account a range of scenarios, including both a recession and the continuation of strong growth.) CBO also projects that CPI inflation will average 2.6 percent during that period, reflecting the agency's assumption about the level of inflation consistent with Federal Reserve policy. Given the projection of continued stable inflation, interest rates are expected to level off at rates similar to those seen in the second half of the 1990s. (See Summary Table 3.)

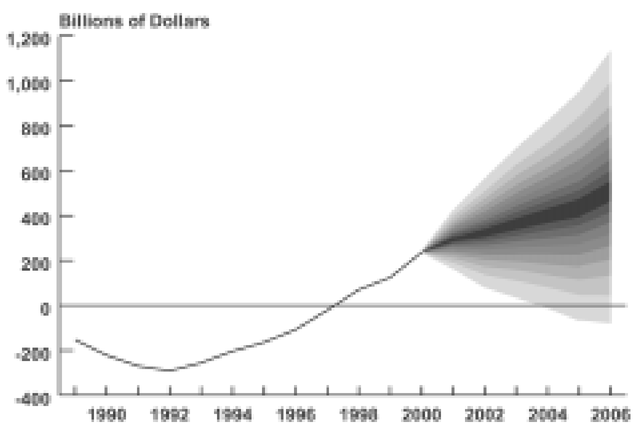
Uncertainty in the Projections

The baseline projections presented in this report represent the midrange of possible outcomes for the economy and the budget, based on past and current trends and the assumption that current policies are not changed. But considerable uncertainty surrounds those projections for two reasons. First, the U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to predict. Second, future legislation is likely to alter the paths of federal spending and revenues. CBO does not predict future legislation—indeed, any attempt to incorporate future legislative changes in its baseline would undermine the usefulness of those numbers as the base against which to measure the effects of such changes. As a result, actual budgetary outcomes will almost certainly differ from CBO's baseline projections.

Experience shows that although CBO's projection of the surplus for the coming fiscal year is likely to err, on average, by about 1 percent of GDP (excluding the effects of new legislation), discrepancies can become more substantial over a five-year horizon. CBO has made 10-year projections only since 1992, so it is too soon to assess their accuracy; but 10-year projections are likely to be less accurate than five-year projections.

In view of those uncertainties, the outlook for the budget can best be described as a fan of probabilities around the point estimates presented in this report. The fan is initially fairly narrow, but then widens as the period extends (see Summary Figure 2). The figure makes clear that nearby projections—other paths in the darkest part of the figure—have nearly the same probability as the baseline. Moreover, projections that are quite different from the baseline also have some significant probability of coming to pass. For example, the figure suggests some probability, albeit small, that the budget might fall into deficit in 2006, even without policy changes.

Summary Figure 2.
Uncertainty in CBO's Projections of the Total Budget Surplus Under Current Policies (By fiscal year)



SOURCE: Congressional Budget Office.

NOTES: The figure shows the estimated likelihood of alternative projections of the surplus under current policies. The calculations are based on CBO's past track record. The CBO projections described in Chapter 1 fall in the middle of the darkest area. Assuming that policies do not change, the probability is 10 percent that actual surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual surpluses will of course be affected by legislation enacted during the next 10 years, including decisions about discretionary spending. The effects of future legislation are not included in this figure.

An explanation of how this probability distribution was calculated will appear shortly on CBO's Web site at www.cbo.gov/otherdoc.html.